ORAL
TESTIMONY OF
J. KENNETH BLACKWELL
OHIO TREASURER OF STATE
PRESENTED BY
RAYMOND C. HEADEN, ESQUIRE
GENERAL COUNSEL TO THE OHIO TREASURER OF STATE
BEFORE THE SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS
H.R. 1053: "THE COMMON CENTS STOCK PRICING ACT OF 1997"
APRIL 16, 1997

Mr. Chairman, members of the subcommittee:

My name is Raymond C. Headen. I am General Counsel to Ohio State Treasurer J. Kenneth Blackwell. It is my pleasure to appear before you today in order to testify the support of Ohio State Treasurer J. Kenneth Blackwell for H.R. 1053, the Common Cents Stock Pricing Act of 1997. As background, Treasurer Blackwell serves as an elected constitutional officer of the State of Ohio and serves as the statutory custodian of Ohio's five public pension funds and Ohio's state insurance fund. In 1996, these funds held assets exceeding $110 billion dollars. Treasurer Blackwell believes H.R. 1053 will lower transaction costs for Ohioans and thereby permit Ohioans to keep significantly more of their savings dollars.

Each year millions of investors spend mind-boggling amounts of money investing in the U.S. equities markets. Yet, as a result of trading stocks in fractions, potentially billions of dollars in additional transaction costs are being paid by these investors not as a result of free market competition but rather as a result of anachronistic market practices and rules that date back to the Spanish dollar being divided into eight pieces. If decimalization were implemented, smaller spreads between a stock's "bid and ask" prices would be possible, thereby lowering trading costs and putting significantly more money into the pockets of investors who could buy stocks for a little less and sell stocks for a little more.

Although lowering the spread may be accomplished by decreasing the fractions associated with stock quotes instead of quoting in decimals, another investor benefit of decimalization is the simplification of the system. Treasurer Blackwell has publicly stressed the importance of increased disclosure, transparency and education as the foundation for sound public fund management. Mr. Chairman, members of the Subcommittee, our society is structured around dollars and cents. Individual investors are familiar and comfortable with decimals. At a time when record numbers of Americans are investing in equity securities, they would be greatly helped by a move from an anachronistic fractional trading system to user friendly plain numbers. While this benefit may seem minor to some, the access and comfort gained by the individual investor from decimalization should not be undervalued.

When stock prices are quoted in dollars and cents, stock prices are set by free market forces rather than by artificial rules and antiquated practices. Competition will naturally escalate, thereby improving efficiency. When limit orders are forced to queue by time precedence at eighth fractions, this is evidence that the laws of supply and demand in the schedules of bids and offers are forced into inefficient step functions.

Decimalizing the current fractional system would mean advanced competitiveness for the nation. The United States is the only industrialized country where markets still quote stock prices in fractions. With the Toronto Stock Exchange decimalizing last April, the United States has the only major markets which resist decimalization. This resistance is inefficient and it is the fiduciary duty of any state treasurer to eliminate inefficiency and lower securities transaction costs for constituents whenever prudent. Everyday fractional quotes must be converted to decimals and then back to fractions for accounting, record keeping, reporting and other analysis purposes. This inefficiency takes time and money and this is an inefficiency the costs of which Ohioans should not have to bear.

Treasurer Blackwell supports the passage of H.R. 1053. It is only common sense.

WRITTEN TESTIMONY
OF
J. KENNETH BLACKWELL
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BEFORE THE SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS
H.R. 1053: "THE COMMON CENTS STOCK PRICING ACT OF 1997"
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Mr. Chairman, members of the subcommittee, it is my pleasure to appear before you today in order to testify on behalf of H.R. 1053, the Common Cents Stock Pricing Act of 1997.

Since the origin of the New York Stock Exchange in 1752, stocks have been traded in fractions of one-eighth. Whether this practice originated from the Spanish peseta being divided into eight pieces, or another practice, while interesting, is not important here. What is important is the *effects* of trading stocks in fractions. While not all of the potential effects of trading in fractions can be discussed here, I would like to address a few of the most prominent effects, and propose a solution - decimalization.

Each year millions of investors spend mind-boggling amounts of money investing in the U.S. securities market. Yet, as a result of trading stocks in fractions, billions of dollars which could potentially benefit investors are benefitting the market makers instead. With the spread between a stock's "bid and ask" prices usually being at least 1/8 of a dollar, or 12.5 cents, the middleman can pair up an investor whose ask price is 12.5 cents per share lower than another investor's bid price, and pocket the difference, and no one is any the wiser. Middlemen figure this as part of their profits. If decimalization were implemented, a smaller spread would be accommodated, thereby lowering trading costs and putting the money into the pockets of investors who could buy for a little less and sell for a little more. "By providing a more flexible pricing structure, market makers or specialists could compete more effectively by reducing the quoted spread more easily and at lower costs, thereby reducing the . . . otherwise higher prices - borne by investors when they trade."[1] When Canada's exchanges moved to decimal pricing, spreads shrank, putting an estimated $150 million into the pockets of investors. Even a one cent reduction in the current 12.5 cent spread would yield an estimated savings to investors of over $1 billion per year.[2] If the average spread were reduced to a nickel, the estimated savings would skyrocket to between $5 and $10 billion per year.

Although lowering the spread may be accomplished by decreasing the fractions associated with stock quotes instead of quoting in decimals, another investor benefit of decimalization is the simplification of the system. Our society is structured around dollars and cents. The individual investor is familiar and comfortable with decimals. "[M]any investors are put off by the current fractional trading system, and they would be greatly helped by a move to user friendly 'plain numbers.' In that regard, decimals is the *only* right step." [3] While this benefit may seem minor to some, the access and comfort gained by the individual investor from decimalization should not be undervalued.

Another major benefit gained by the conversion of our market quotes to decimals from fractions is market efficiency. Because the price spread is always an eighth or more, it now costs a stock trader at least 12.5 cents to put in a better price to get an order filled immediately. The alternative to this costly option is to join the line in the limit order book. Even upon joining the line in the limit book, a stock trader must lower his expectations to get to the front of the line:

> To obtain precedence in the order book, the trader must improve the prevailing bid or offer by a minimum of one eighth. Since it is expensive to compete on price, limit orders queue by time precedence at the eighth fractions. Basic economic theory says that such queues are *ipso facto* evidence of a wrong price. The naturally smooth demand and supply schedules of bids and offers are forced into lumpy step functions.
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> Now imagine what would happen if decimalization reduced the price of precedence in the order book by 92% from on eighth to one cent. Instead of queuing by time precedence, limit orders are now prioritized by price. The demand and supply schedules assume the natural smooth shape. Equilibrium bid and offer prices are resolved to the nearest penny. The price is right. Efficiency is improved. . . .[4]

When stock prices are quoted in dollars and cents, stock prices are set by market forces rather than by artificial rules and antiquated practices. Competition will naturally escalate, thereby improving efficiency.

Decimalizing the current fractional system would mean advanced competitiveness for the nation. The United States is the only industrialized county where markets still quote stock prices in fractions. With the Toronto Stock Exchange decimalizing last April, the United States has the only major markets which resist the conversion. Fractionalized quotes must be converted to decimals and back every day for accounting, record keeping, reporting and analysis, among other reasons. This takes time and money. "Moreover, as technological change moves us toward a more global securities market, our failure to provide for a more flexible and market-oriented pricing system will represent a serious competitive disadvantage to our markets vis-a-vis other international markets, and increasingly cause problems as our other domestic markets - namely our derivatives markets which trade in decimals - become further interlinked with our equity markets."[5] This is a disadvantage we can scarce afford to impose upon our markets.

The arguments against decimalization are numerous and varied, but there are a few arguments which seem to be voiced with the most frequency.

One argument against decimalization is that there is no need for a change, the current system operates just fine. While it is true that our markets have performed well over the last two hundred years, the goal is not to maintain the status quo, but to preserve America's markets as the best. Decimalization will encourage the laws of free trade to regulate our exchanges, thereby alleviating the need we now have for many of the rules governing trading in our markets. The fact that investors are not complaining about the system cannot be used as an excuse to resist the change, either. "If one or more market centers can offer the service of executing trades at better prices because trading can be conducted with narrower spreads, investors will demand this improved service."[6]

Another oft quoted argument against decimalization of our markets is the price tag associated with the conversion. Even assuming that the cost of this conversion would be several hundred million dollars, which seems to be the highest estimate to date, this cost would be a one-time cost to the exchanges. Furthermore, the savings realized from a smaller trading increment are 1) much greater and 2) recurring, so that over time the cost of conversion of the systems is dwarfed by the savings realized exclusively from the narrowed spreads, not to mention the other benefits discussed above.

Another concern expressed by opponents of decimalization is a reduction in market liquidity as a result of some market makers abandoning their functions. "A standard 'law of the marketplace' response to the concerns about a market maker shakeout is that if profits contract, the more able and efficient makers will stay and the less able and efficient will simply go."[7] This "law of the marketplace" is what governs the success or failure of firms in other industries every day. Furthermore, market makers can recreate the profits they may or may not lose should decimalization narrow spreads through increased commissions, for example. Market makers will also experience reduced trading costs from the narrow spreads, and some analysts estimate that this will increase trading volume, thereby leaving the market makers better off after decimalization.[8]

In addition to the benefits discussed here, many believe that decimal pricing will stop such practices as payment for order flow, fragmentation, and internalization. Decimalization is the single best change we can make to our markets today. It will not only benefit investors, but the markets and the United States as well. Thank you.

ENDNOTES

1. Technology and Our Markets : Time to Decimalize, Remarks of Commissioner steven M. H. Wallman before the Center for the Study of Equity Markets, Pace University, September 25, 1996.

2. Junius W. Peake, "Brother, Can You Spare a Dime? Let's Decimalize the U. S. Equity Markets!" Presented at the Global Equity Markets Conference, Stern School of Business, New York University, October 21021, 1993.

3. See Wallman, 1996.

4. Decimal Quotes: The Price is Right, Jeffrey P. Ricker, CFA

5. See Wallman, 1996.

6. See Peake, 1993.

7. Memorandum from Gary W. Shorter, Economic Analyst at Congressional Research Service, The Library of Congress, Economics Division, to Congressman Michael Oxley.

8. See Ricker.